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IN THE

Supreme Court of the United States

OCTOBER TERM, 1957

No. 981

THE PITTSTON COMPANY,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

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COMMISSIONER OF INTERNAL REVENUE,

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

The petitioner prays that a writ of certiorari be issued to review the judgment (R. Vol. II, p. 43 and Appendix A hereto) of the United States Court of Appeals for the Second Circuit reversing the judgment of the Tax Court of the United States (R. Vol. I, p. 30).

Opinions Below.

The opinion of the Tax Court (R. Vol. I, p. 24) is reported in 26 T. C. 967. The majority opinion and the dissenting opinion of the Court of Appeals (R. Vol. II, p. 25 and Appendix B hereto) are reported in F. 2d .

Jurisdiction.

Jurisdiction to issue the writ prayed for is vested in this Court by Section 1254 of Title 28 of the United States Code. The judgment of the Court of Appeals (R. Vol. II, p. 43 and Appendix A hereto) was entered on February 11, 1958.

Question Presented.

Did a transfer for a lump sum by a coal dealer to a mine owner of the dealer's contract right to purchase the entire output of the mine for a period of years constitute a sale of a capital asset by the dealer resulting in capital gain rather than ordinary income?

The Tax Court held that the transaction was a sale, but the Court of Appeals, disregarding controlling decisions to the contrary in the Third, Fifth and Tenth Circuits, reversed the Tax Court over a strong dissent by Judge Moore.

Statutes Involved.

The statutes involved are Sections 22 (a), 117 (a)(1) and 117 (a)(4) of the Internal Revenue Code of 1939 as more fully set forth in Appendix C attached hereto.

Summary Statement of Matter Involved.

In 1944 Russell Fork Coal Company wanted to secure financial aid to enable it to install and equip a coal mining plant on coal lands which it held under lease in Pike County, Kentucky. To that end it negotiated a deal with Pattison & Bowns, Inc., a subsidiary of the petitioner, hereinafter called the taxpayer, whereby the taxpayer agreed to

advance the necessary funds on ten-year notes, in consideration of Russell Fork granting to it the exclusive right to purchase the entire output of the mine for a period of ten years and such longer period as any of the notes should remain unpaid. The deal was reflected in two agreements entered into on the same date, January 25, 1944.

In one agreement, which may be called the financing agreement, the taxpayer agreed to advance $250,000 for the installation of a coal mining plant. The expenditure of the amounts advanced was to be subject to the approval of a director of Russell Fork to be designated by the taxpayer, who was also empowered to fix the executive salaries to be paid by Russell Fork. No dividends could be paid by Russell Fork so long as any of the advances remained unpaid, all earnings otherwise available for dividends being required to be applied to the repayment of the advances. Also, ten cents per ton was to be deducted by the taxpayer from the price of all coal purchased by it from Russell Fork and applied toward repayment of the advances. Russell Fork had the right to prepay the notes and also the right to extend any of them for a further period of ten years.

The second contract, which may be called the purchase agreement, gave the taxpayer the exclusive right to purchase the entire output of the mine for a period of ten years and such further period as any of the taxpayer's advances might remain unpaid, at prices which were eight percent less than the resale prices of the coal as fixed by Russell Fork from time to time. Russell Fork was forbidden to sell any coal to others at lower prices, and the taxpayer was also entitled to an amount equal to eight percent of the gross selling price of any coal which it failed to purchase and which was therefore sold to others by Russell Fork.

The taxpayer advanced the $250,000 called for by the financing agreement and in addition made further large advances from time to time. The total indebtedness of Russell Fork to the taxpayer rose to a peak of $881,417.54 by December, 1946, but by the end of 1948 all advances had been repaid. Up to that time, Russell Fork had delivered to the taxpayer 1,645,452.75 tons of coal at a net cost to the taxpayer of $7,484,706.53.

On October 14, 1949, Russell Fork paid the taxpayer $500,000. for all of the taxpayer's "right and interest in and to" the purchase agreement, thus resulting in its cancellation by operation of law. By that time the total coal deliveries under the agreement amounted to 1,959,563.15 tons at a net cost to the taxpayer of $9,131,678.50.

The record does not disclose how much, if any, profit or income the taxpayer realized from its resales of coal purchased under the agreement, nor how much, if any, of the output of the mine was sold to others during the life of the agreement, nor how much coal the taxpayer would have been entitled to purchase over the remaining life of the agreement had it not been cancelled. The consideration for the transfer of the purchase agreement, a capital asset, was similar to consideration paid for the transfer of shares of stock and was not a substitute for the right to receive ordinary income in the future, as in *Commissioner* v. *P. G. Lake, Inc.*, U. S. , decided by this Court April 14, 1958.

The Tax Court and the entire Court of Appeals, as well as Government counsel, agree that the purchase agreement was a capital asset of the taxpayer and that a transfer of the taxpayer's rights under the agreement to anyone other than Russell Fork for a lump sum would have constituted a sale resulting in capital gain. The Tax Court and Circuit Judge Moore concluded that the same result should follow

from the transfer to Russell Fork, although as Russell Fork was the other party to the agreement the transfer resulted in the cancellation of the agreement. District Judge Smith, with Chief Judge Clark concurring, ruled otherwise.

Specification of Errors.

The Court of Appeals erred:

1. In reversing the judgment of the Tax Court.

2. In holding that the transfer of the taxpayer's rights under the sales agreement to Russell Fork for $500,000 was not a sale resulting in capital gain because Russell Fork was the other party to the agreement.

Reasons for Granting the Writ.

1. The Court of Appeals has rendered a decision in conflict with the decisions of three other Courts of Appeals on the same subject matter.

(a) The decision of the Court of Appeals that the taxpayer's surrender of its exclusive right to purchase the entire output of Russell Fork's coal mine, in consideration of a lump sum payment of $500,000 did not constitute a sale, is in conflict with the decision of the Tenth Circuit in *Jones* v. *Corbyn*, 186 F. 2d. 450, in which it was held that where general agents of a life insurance company surrendered their exclusive general agency for a lump sum payment they thereby made a sale of a capital asset. Although the court below did not discuss *Jones* v. *Corbyn* in its opinion in the instant case, it cited it with other cases in a footnote to a statement (R. Vol. II, p. 30 and p. 17 Appendix B hereto) that: "The courts have not been

entirely consistent in their treatment of lump sum payments received by a taxpayer for the termination of jural relations between the taxpayer and another * * *". The conflict between the decision below and *Jones* v. *Corbyn* is further shown by the fact that the Court below based its decision in this case largely on its earlier decision in *Commissioner* v. *Starr Bros.*, 204 F. 2d. 673, in which it had expressly disapproved and refused to follow *Jones* v. *Corbyn*. The Third and Fifth Circuits, in decisions with which, as we shall show, the decision below is also in conflict, have approved *Jones* v. *Corbyn*, and have refused to follow the *Starr* case.

(b) The decision below also conflicts with the decision of the Fifth Circuit in *Commissioner* v. *Ray*, 210 F. 2d. 390, cer. den. 348 U. S. 829, to the effect that a tenant made a sale when for a consideration he released his landlord from a covenant in the lease which prohibited the landlord from renting adjoining premises to a competitor. We think the *Ray* case might have been decided differently on the ground that it involved only a release of a negative covenant, but if the *Ray* case was correctly decided then *a fortiori* the Court of Appeals erred in the case at bar where the taxpayer gave up all of its rights to purchase and resell Russell Fork's coal. In applying for certiorari in the *Ray* case, counsel for the Commissioner argued that the *Ray* case was in conflict with the *Starr* case. Counsel said (Suppl. Memo., p. 3) that "no valid distinction can be drawn between the provisions of a lease giving the lessee the right to have all competitors excluded from leasing space in a building * * * and contract rights giving the exclusive right to sell a product in a certain area, the release of which was held not to be a sale or exchange in *Starr Bros.*, supra." It will be noted that the *Starr* case also involved only the release of a negative covenant, as

only the exclusive feature of the agency or distributorship was released.

(c) The decision below squarely and directly conflicts with the decision of the Third Circuit in *Commissioner* v. *Goff*, 212 F. 2d. 875, cer. den. 348 U. S. 829, in which it was held that the surrender of a contract entitling the taxpayer to purchase the entire output of a hosiery-making machine constituted a sale of a capital asset. Judge Goodrich based the decision in *Goff* on both *Jones* v. *Corbyn* and *Commissioner* v. *Ray*. In refusing to follow the Second Circuit's decisions in *Starr Bros.* and *General Artists Corp.* v. *Commissioner*, 205 F. 2d. 360, cer. den. 346 U. S. 866 (holding that a cancellation of a theatrical agent's contract with an artist was not a sale), Judge Goodrich said, p. 876:

> "But the last word on the subject in the Second Circuit is *Commissioner of Internal Revenue* v. *McCue Bros. & Drummond, Inc.* (1954), 219 Fed. 2d 752, which held that payment made by a lessor to a lessee so that he would vacate the premises was a capital gain. The *Starr* and *General Artists* decisions were distinguished on the ground that the rights there involved were less substantial. Whether the Second Circuit cases are in harmony is not a matter for us to decide. The last decision is certainly in accord with the cases cited above, and we think it is right."

The majority opinion below does not discuss the *Goff* case but merely includes it in the list of cases cited in the footnote to the statement already referred to, concerning the lack of harmony in the decisions as to the tax treatment to be accorded lump sum payments received by a taxpayer for the termination of jural relations between the taxpayer and another. Fundamental disagreement with the rationale of the *Goff* case is shown, however, in the reasoning of the

majority of the court below that the taxpayer's right to the output of the mine "was a naked contract right, not in the nature of a lease or profit *a prendre*." Surely the right in the *Goff* case to the output of a hosiery machine was of no greater dignity. Moreover, Judge Moore in his dissent below cites authority to show that the taxpayer's rights in this case were so unique and fundamental as to entitle it to specific performance.

We submit that the majority of the court below erred grievously in placing its decision on such a highly debatable and in any event meaningless distinction between simple contract rights and what it appears to consider the "more substantial" rights inhering in leaseholds and profits *a prendre*. Surely there is no room in our tax law for such subtleties.

2. The Court of Appeals has decided an important question of federal tax law which has not been, but should be, decided by this Court.

For many years the lower federal courts have struggled with the question whether "a termination of jural relations" for a consideration constitutes a sale resulting in capital gain. As the majority conceded in its opinion below, the decisions have not been "entirely consistent". Judge Raum, who wrote the Tax Court opinion in the case at bar, has called attention to the difficulty that Court has had, without the benefit of guidance from this Court, in trying to evolve a workable rule out of the conflicting decisions in the Courts of Appeals. In *Marc D. Leh*, 27 T. C. 892, Judge Raum said, at page 898:

> "If these distinctions are not wholly satisfying, it should be remembered that the Supreme Court was requested to issue writs of certiorari in a number of these cases in order to clarify the situation, but

> it refused to do so. In the circumstances, we must do the best we can with the precedents at hand, * * *".

Concededly, as the majority below pointed out, a line must be drawn somewhere. But whether the controlling distinction should be between a release of negative rights and a release of positive rights, or between general contract rights and contract rights relating to specific property, or even between transfers to third parties and releases to the other contracting party (apparently the Commissioner's real position) need not now be considered. The Court below, in drawing the line in this case between simple contract rights and what it considers the "more substantial" rights relating to real property and chattels real, has come squarely into conflict with other Courts of Appeals, has set up a criterion having no relationship whatever to the underlying question of capital gain versus ordinary income, and has, moreover, probably erred in considering the taxpayer's rights to be merely simple or naked contract rights.

As to the importance of the question involved in this case, we can do no better than quote the last paragraph of Judge Moore's dissenting opinion:

> "In no branch of the law is it more important that there be as much certainty as possible than in the field of taxes. Businessmen and their corporations must often make decisions involving future plans and the expenditure of large sums of money upon the advice of counsel as to the tax consequences of the contemplated transactions. The decision of the majority in the present case injects an unwarranted inconsistency into this field. In my opinion the Tax Court correctly construed the decisions in this as well as the other circuits referred to and its judgment below should be affirmed."

Conclusion.

It appearing that the decision below is in conflict with decisions in other circuits and is probably erroneous, and that the question involved is one of substantial importance with which the Tax Court and various Courts of Appeals have had great difficulty over a long period of time, a writ of certiorari should issue so that the question may be settled by this Court.

May 2, 1958.

Respectfully submitted,

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Appendix A.

Judgment.

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the 11th day of February, one thousand nine hundred and fifty-eight.

Present:

Hon. CHARLES E. CLARK, Chief Judge
Hon. LEONARD P. MOORE, Circuit Judge
Hon. J. JOSEPH SMITH, District Judge

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

PITTSTON COMPANY,
Respondent.

Appeals from The Tax Court of the United States.

This cause came on to be heard on the transcript of record from The Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is reversed and action remanded for entry of judgment in favor of the Commissioner in accordance with the opinion of this court.

A. DANIEL FUSARO,
Clerk.

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT
FILED FEB 11 1958
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Appendix B.

Majority Opinion and Dissenting Opinion.

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 32—October Term, 1957.

(Argued December 6, 1957 Decided February 11, 1958.)

Docket No. 24531

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

THE PITTSTON COMPANY,
Respondent.

Before:

CLARK, Chief Judge,

MOORE, Circuit Judge, and SMITH, District Judge.

On petition for review of the decision of the Tax Court of the United States, Arnold Raum, Judge, 28 T. C. No. 967.

The Commissioner of Internal Revenue petitions for review of a decision of the Tax Court holding that the cancellation, in 1949 of respondent taxpayer's exclusive contract right to purchase Russell Fork Coal Company's entire coal output constituted a "sale or exchange," within the meaning of Section 117(a)(4) of the Internal Revenue Code of 1939, entitling taxpayer to treat the $500,000 received upon the cancellation as long-term capital gain rather than ordinary income. Reversed and remanded.

DAVID W. MORTON, JR., Atty., Dept. of Justice (Charles K. Rice, Asst. Attorney General, Ellis N. Slack, Harry Baum, Attys., Dept. of Justice, on the brief), for petitioner.

ROLLIN BROWNE, New York City (Joseph J. Pugh, and Satterlee, Browne & Cherbonnier, New York City, on the brief), for respondent.

SMITH, District Judge:

This is a petition by the Commissioner of Internal Revenue for review of a decision of the Tax Court of the United States reported in 26 T. C. No. 967, holding the taxpayer The Pittston Company entitled to treat the sum of $500,000 received in 1949 as consideration for the termination of an exclusive contract to purchase the output of Russell Fork Coal Company's leased Pike County coal mines, as long term capital gain, derived from a sale or exchange within the meaning of Section 117(a)(4) of the Internal Revenue Code of 1939. The pertinent sections of the statutes are as follows:

> "Section 22. GROSS INCOME. (26 U. S. C. 1952 ed. Sec. 22)
>
> (a) General Definition.—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal services of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *
>
> * * * * * * *
>
> "Section 117. CAPITAL GAINS AND LOSSES. (26 U. S. C. 1952 ed., Sec. 117)
>
> (a) Definitions.—As used in this chapter—
>
> (1) (As amended by Sec. 115(b), Revenue Act of 1941, c. 412, 55 Stat. 687, and Sec. 151(c), Revenue Act of 1942, c. 619, 56 Stat. 798) Capital Assets.—The term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would

> properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), or an obligation of the United States or any of its possessions, or a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, or real property used in the trade or business of the taxpayer;
>
> * * * * * *
>
> (4) (As amended by Sec. 150(a)(1), Revenue Act of 1942, supra) Long-Term Capital Gain.—The term 'long-term capital gain' means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing net income;
>
> * * * * * * ,,

The Pittston Company and its wholly owned subsidiary, Pattison & Bowns, Inc., filed consolidated returns for the taxable year 1949. The subsidiary, which was the contracting party with Russell Fork Coal Company (hereinafter called Russell) and the recipient of the amount in question, will be referred to as the taxpayer.

On January 25, 1944, taxpayer (as buyer) and Russell (as seller) entered into a written contract, which provided, in part, as follows:

> "That in consideration of the mutual covenants and conditions herein set forth and of an agreement executed and delivered simultaneously with the execution and delivery of this agreement, it is agreed as follows:

"(1) Subject to the provisions of Paragraph 2 of this agreement the Seller (Russell Fork) agrees to sell to the Buyer (Pattison & Bowns), and any other affiliated person, partnership or corporation whom and which the Buyer may from time to time designate in writing, F.O.B. the mine, all of the coal which shall be mined and sold for resale from the mining plant or plants which the Seller expects to install or does install upon its leased property in Pike County, Kentucky, as set forth in the agreement executed simultaneously herewith.

* * * * * *

"(3) The title to all coal sold to the Buyer hereunder shall pass to the Buyer at the time said coal is loaded into cars or trucks at the mines for transportation and before transportation begins.

"(4) The Buyer shall be entitled to and is hereby authorized to deduct a discount of 8% of the gross selling price on all coal purchased by it, which amount shall include all expenses and compensation of every kind of the Buyer and its designees and under no circumstances shall any affiliate of the Buyer be entitled as a wholesaler, jobber or otherwise to any additional discount, compensation and expenses all of which shall be included in the foregoing 8%, * * *

* * * * * *

"(6) The Buyer agrees for itself and its designees and binds itself and each of them that it and each of them will at all times have and maintain proper facilities and employees so as to be able efficiently to resell the said coal and agrees to endeavor with diligence and in every proper manner to resell the largest available amount of said coal at prices specified from time to time by the Seller, and further agrees to comply with all laws that are now in force, or may hereafter be enacted, and all

> valid rules and regulations thereunder relating to the selling of coal or all other related or incidental matters. * * * if the Buyer and its designees, as the case may be, complies with the obligations binding upon it and them, then this agreement shall be irrevocable for a period of ten (10) years from this date and for such additional period of extensions as is provided in Paragraph 3 of the agreement executed and delivered simultaneously with the execution and delivery of this agreement. * * * "

On the same date, January 25, 1944, taxpayer and Russell entered into another contract, under the terms of which taxpayer agreed to loan Russell $250,000, which loan was to be repaid in periodic installments over a period of 10 years and was to bear interest at 4 per cent per annum. During the period January 25, 1944 to October 14, 1949, taxpayer purchased from Russell 1,959,563.15 tons of coal for $9,855,089.64 which it resold at a gross profit of $273,411.14. Taxpayer carried out its agreement to loan Russell $250,000 and it also made various additional advances on open account; these loans were finally liquidated by Russell during 1948. On October 14, 1949, Russell paid $500,000 to taxpayer in consideration of taxpayer's surrender of all of its rights under the coal agreement of January 25, 1944. The transaction was reflected in a letter agreement dated October 14, 1949; the letter was sent to Russell by taxpayer, and read as follows:

> "In consideration of the payment by you to us of the sum of Five Hundred Thousand Dollars ($500,000), receipt of which is hereby acknowledged, it is understood that you have as of this day acquired all of our right and interest in and to the agreement dated January 25, 1944 between us, which agreement provides for the exclusive right by Pattison & Bowns, Inc. to purchase all of the coal produced by you at your Russell Fork Mine, said contract expiring by its terms on January 25, 1954."

In its income tax return for the year 1949, taxpayer reported the $500,000 as long-term capital gain. In his notice of deficiency, the Commissioner determined that this amount "was not received as the result of a sale or exchange and therefore is reportable as ordinary income." The Tax Court held that the $500,000 was taxable as long-term capital gain, not as ordinary income, and accordingly overruled the Commissioner.

The courts have not been entirely consistent in their treatment of lump sum payments received by a taxpayer for the termination of jural relations between the taxpayer and another as falling within or without the area entitled to more favored treatment as long-term capital gains rather than ordinary income.[1] This circuit has steered a middle course. In *McAllister* v. *C. I. R.*, 2 Cir., 157 F. 2d 235, payment received for transfer by a taxpayer of a life interest in a trust to a remainderman was held a capital gain, Judge Frank dissenting. The *McAllister* holding and its possible consequences were criticized in Judge Frank's dissent and in comments on the problem in law journals (see 56 Yale L. J. 570-574 and 14 U. of Chic. L. Rev. 484-493). The court thereafter held in *C. I. R.* v. *Starr Bros.*, 2 Cir., 204 F. 2d 673, that payment received by a taxpayer, a New London retail druggist, for relinquishing its rights under a provision in a contract with a manufacturer, binding the manufacturer not to sell drugs to taxpayer's competitors in New London, was ordinary income and not a capital gain. In the same year, consistently with *Starr*, the Court in *General Artists Corp.* v. *C. I. R.*, 2 Cir., 205 F. 2d 360, cert. den. 346 U. S. 866, held that payments received by a taxpayer for transfer of its contracts with a singer as his exclusive booking agent to another such agent by an agreement pro-

[1] *Bingham* v. *C. I. R.*, 2 Cir., 105 F. 2d 971; *McAllister* v. *C. I. R.*, 2 Cir., 157 F. 2d 235; *Jones* v. *Corbin*, 10 Cir., 186 F. 2d 450; *C. I. R.* v. *Golonsky*, 3 Cir., 200 F. 2d 72; *C. I. R.* v. *Starr Bros.*, 2 Cir., 204 F. 2d 673; *General Artists Corp.* v. *C. I. R.*, 2 Cir., 205 F. 2d 360; *C. I. R.* v. *Ray*, 5 Cir., 210 F. 2d 390; *C. I. R.* v. *McCue Bros. & Drummond, Inc.*, 2 Cir., 210 F. 2d 752; *C. I. R.* v. *Gaff*, 3 Cir., 212 F. 2d 875; *Roscoe* v. *C. I. R.*, 5 Cir., 215 F. 2d 478; *Marc D. Leb*, 27 T. C. No. 110.

viding for cancellation of the contracts and execution of new contracts with the singer by the transferee were ordinary income and not capital gains received as gain from sale of a capital asset. However, in *C. I. R.* v. *McCue Bros. & Drummond Inc.*, 2 Cir., 210 F. 2d 752, the court held a payment received by a taxpayer lessee from a landlord for vacating premises where the taxpayer had a right to continued possession under rent control laws was a capital gain from the sale or exchange of a capital asset held more than six months. In so doing the court followed the third circuit in *C. I. R.* v. *Golonsky*, 3 Cir., 200 F. 2d 72, cert. den. 345 U. S. 939, holding payment received by a lessee from the landlord for cancelling the lease and surrendering the premises to be a capital gain. The court distinguished *Starr* and *General Artists* because there the contractual right was not transferred but was released and merely vanished. The right to possession of the realty was considered a more substantial property right which does not lose its existence when it is transferred.

The Tax Court in the instant case concluded that the contractual right held by the taxpayer constituted capital assets, which petitioner does not dispute, and concluded that the right was not extinguished by its cancellation, but continued to exist as property of the transferee-payor. It distinguished *Starr* and *General Artists* on the ground that the court had held in those cases the contractual right was not transferred, but was released and merely vanished. The Tax Court says in effect that the extinguishment of a contract duty to deal only with one person transfers to the one formerly bound a right to deal with all the world. It would be more in accord with common understanding to say that the payment is solely for the termination of the right-duty relationship between the two parties to the agreement. To be sure, the same might be said of the termination of lessee's or life tenant's rights, but they have been distinguished as relating to matters of greater "substance" than mere contract rights.

The instant case appears on the facts closer to the payment for the extinguishment of the taxpayer's rights under

the negative covenant in *Starr* than to the cases such as *McAllister* where a life estate was transferred to the remainderman, or the release of right to possession of realty under lease or otherwise as in *McCue* and in *Golonsky*. While the contract right here surrendered was "property" of value it carried with it no direct interest in the mine itself, or in the coal produced until delivery f.o.b., car or truck. It was a naked contract right, not in the nature of a lease or profit *à prendre*. If Russell Fork was able to do better elsewhere it might have sold its coal through anyone, responding in damages to the taxpayer, for so far as appears similar coal would have been obtainable elsewhere by taxpayer at a price. The large amount received by the taxpayer for the 4½ years the contract had to run compared with its gross returns for the 5½ years already expired, while not explained on the record, may reflect an expectation of lower expense to the taxpayer since taxpayer no longer is financing Russell. In any case, the cancellation brought the taxpayer at one time a return which it might otherwise have realized over a relatively short period of years as ordinary income under the sales contract. Whatever brought it about, it suggests a possible method of returning future income to a taxpayer in a lump sum from the other contracting party in advance for tax avoidance purposes, which the court has been unwilling to sanction except where the consideration surrendered had more "substance" than mere contract rights.

The Congress has since the tax year here in question more fully provided for the application of the sale or exchange concept when a lease or distribution agreement is cancelled, by Section 1241 of the Internal Revenue Code of 1954, allowing the more favorable capital gains treatment of the amount received on cancellation, but in case of distributorships only where the distributor has a "substantial investment" in the distributorship, as in facilities for storing, processing, etc. the physical product or as in maintaining a substantial inventory. This amendment is not applicable in this case, and of course no showing was made as to whether such a substantial investment in facilities or

inventory was or was not maintained. The amendment is of little assistance in interpreting the original provision for we cannot tell whether the intent of Congress was to broaden or narrow the capital gains on sale or exchange exception to the income tax, and its apparent result falls somewhere between the contentions of the opposing parties here. See Senate Report on H. R. 8300, 3 U. S. Code Cong. & Adm. News, 83rd Cong., 2nd Session, 1954, p. 5087, 5088, Conf. Report, *id.* p. 5332. The heavy burden of income taxation inevitably leads to the broadening of exceptions such as the capital gains provision. This court has endeavored to define what it conceived to be the limits to this exception in *Starr* and *United Artists* by a somewhat literal definition of "sale or exchange." Even though the logic of setting the limit by drawing the line where it now is may be open to debate, any line set must be to some degree arbitrary. This case falls outside the limit thus far set for the exception by this court. We should leave further expansion of the exception, to include the release of naked contract rights as a "sale," to legislative action.

The judgment of the Tax Court is reversed and the case is remanded for entry of judgment in favor of the Commissioner in accordance herewith.

MOORE, Circuit Judge (dissenting):

I dissent. The assumption of the majority that mere "naked contract rights" form the basis of this transaction is, in my opinion, contrary to the undisputed facts and the law applicable thereto.

The only question involved upon this appeal is whether the sum of $500,000 paid by Russell to Pittston on October 14, 1949 for which Russell "acquired all of our [Pittston's] right and interest in and to the agreement dated January 25, 1944 between us," should be taxed as a long-term capital gain or as ordinary income. The answer to this question depends upon a precise analysis of the rights and interests then existing between the parties.

In 1944 Russell held a lease on certain real estate in Pike County, Kentucky. In order to enable it to install a coal mining plant thereon Pittston, pursuant to a contract with

Russell dated January 25, 1944, agreed to loan Russell $250,000 to be advanced in such amounts as required for "the installation by it of a coal mining plant, and for the operation thereof" (Exh. 1-A). Pittston was given the right to designate a director or directors to the extent of one-third of the board and Russell's expenditures of the proceeds of the loan had to be approved by him or them. Restrictions were placed upon the payment of salaries to Russell's officers and the use of net earnings. Notes evidencing the loan were to be secured by a mortgage upon the lease and structures to be placed upon the property. At the same time Russell and Pittston made a second contract whereby Russell agreed to sell to Pittston "all of the coal which shall be mined and sold for resale from the mining plant or plants which the Seller expects to install or does install upon its leased property in Pike County, Kentucky, as set forth in the agreement executed simultaneously herewith," i.e., the loan agreement, for a period of ten years. Ten cents per ton was to be deducted by Pittston from all coal sold "pursuant to the coal sales agreement entered into simultaneously herewith" to be applied to the loan. By reason of these provisions the $250,000 loan was repaid by the end of 1948.

Thus, the business arrangement between these companies was not confined to a "naked contract right" (as the majority holds) to buy coal but was an integrated transaction whereby Pittston financed the construction of a coal mining plant on Russell's leasehold and agreed to take the entire output, f.o.b. the mine, for ten years with conditional extension possibilities. The two simultaneous agreements, each referring to the other, evidenced the transaction. These contract rights can only be rendered "naked" by stripping from them and discarding the raiments which the parties found to be essential. To say that Russell despite its commitment could sell to anyone responding only in damages on the assumption that similar coal could have been obtained elsewhere (as to which there is no proof in the record) is, first, to suggest that these companies would not honor their mutual obligations and, second, that the courts

in view of the investment of Pittston in the Russell operation and the nature of the agreement (entire output for a period of years) would restrict relief to damages. "Contracts for the delivery of goods will be specifically enforced, when by their terms the deliveries are to be made and the purchase price paid in installments running through a considerable number of years" (*Eastern Rolling Mill* v. *Michlovitz*, 157 Md. 51, 145 A. 378, 383). Specific performance is particularly applicable to a contract "to continue over a period of years without rigidity of price" (*Hunt Foods* v. *O'Disho*, 98 F. Supp. 267, N. D. Cal., 1951, a contract to sell to plaintiff defendant's entire peach crop for a period of five years at prices to be fixed by a Canning Association). See also *Michigan Sugar Co.* v. *Falkenhagen*, 234 Mich. 698, 220 N. W. 760 (a contract to sell entire output of sugar beets grown in a given area—specific performance decreed against vendor); *Pittenger Equipment Co.* v. *Timber Structures*, 217 P. 2d 770.

The mutual rights and obligations created by these two agreements were most substantial. Russell as effectively deprived itself of any other use of its property for ten years as the owner of a building granting a leasehold for ten years to a tenant who had loaned the money to construct it. Russell could only regain for itself the unrestricted use of its property by a surrender by Pittston tantamount to the voluntary termination of a leasehold prior to the expiration date. Pittston, in turn, not only had an investment in Russell's lease, plant and equipment but had a property right to acquire the entire output of the Russell mine which proved to be a right of substantial value.

Nor can the $500,000 payment be regarded as anticipated income for the five remaining years of the contract. As the majority concede, the large amount paid bears no relationship to future income projected on the basis of the gross income realized by Pittston for the previous five and one-half years. Pittston's income was not assured or guaranteed; it was entirely dependent upon its ability to conduct its business operations at a profit. The $500,000 paid was the value to Russell to get its property back and also repre-

sented Pittston's opinion of the contract's worth. If the contract were assigned to a third party there would be no question that the consideration received would reflect the value of the asset sold. Yet for all practical purposes Pittston by such assignment would thereby have terminated or cancelled its right to purchase coal from Russell.

In endeavoring to find a guide as to the type of transaction which will be construed as resulting in a capital gain as distinguished from ordinary income, the decisions reveal uniform consistency in holding that the surrender, termination or cancellation for monetary consideration of a capital asset results in a capital gain. Neither the petitioner nor the majority assail the correctness of the Tax Court's conclusion that the contract right here was in itself a capital asset. For this reason I must disagree with the majority that "the termination of the right-duty relationship between the two parties" results in ordinary income to the taxpayer; particularly since they concede that "the same might be said of the termination of the lessee's or life tenant's rights" which clearly produces a capital gain. Judge Goodrich noted the fallacy of this approach when he wrote "To call the transaction a cancellation or termination of a lease and not a sale is, we think, to assume the point to be decided." (*Commissioner of Internal Revenue* v. *Golonsky*, 3 Cir., 1952, 200 F. 2d 72, 73.) In *Golonsky* a tenant had surrendered possession of leased premises prior to the expiration of the lease upon the payment of a sum of money. Holding this to be a capital gain the court said "Undoubtedly there is a cancellation of the lease when the tenants voluntarily surrender the premises to a landlord in accordance with an agreement, but the fact that the cancellation occurs does not negative the fact that the transaction may constitute a sale."

Searching for a firmer support, an attempt is made to find in the words "substance" or "substantial rights" whether a capital asset is involved and then give uniform treatment regardless of whether the asset is "sold" or "terminated." Prior to the decision of the majority in this case there seemed to be consistency among the various Courts of

Appeals in applying this test. In 1950 the Tenth Circuit (*Jones* v. *Corbyn*, 10 Cir., 1950, 186 F. 2d 450) held that the surrender of an exclusive life insurance agency to an insurance company for a lump sum payment of $45,000 was a long-term capital gain and not ordinary income. Answering the Collector's argument that the contract was not a capital asset the court said "The contract or franchise had at all times substantial value. It was capable of producing income for its owner. It was enforceable at law and could be bought and sold" (p. 452). The court's conclusion was that "By terminating the contract and transferring the business to the company, there was a sale and transfer of a capital asset within the meaning of the statute" (p. 453). In the Fifth Circuit a lessee merely surrendered to his lessor a restriction against renting any space in the block to a Variety Store for which surrender he received $20,000. Despite the fact that this was the surrender of only one of the many rights granted under the lease the court affirmed a decision of the Tax Court in holding the amount received to be a capital gain (*Commissioner of Internal Revenue* v. *Ray*, 5 Cir., 1954, 210 F. 2d 390). In the same year this Court in *Commissioner of Internal Revenue* v. *McCue Bros. & Drummond, Inc.*, 2 Cir., 1954, 210 F. 2d 752, held that the payment of $22,500 to a lessee to vacate store premises to enable another tenant to occupy the space constituted a capital gain and affirmed a Tax Court decision to that effect. This Court agreed both with the *Ray* decision and the decision of the Third Circuit in *Commissioner of Internal Revenue* v. *Golonsky*, 3 Cir., 1952, 200 F. 2d 72, cert. den. 345 U. S. 939, 73 S. Ct. 830, 97 L. Ed. 1366. The court distinguished its previous decisions in *Commissioner of Internal Revenue* v. *Starr Bros., Inc.*, 2 Cir., 1953, 204 F. 2d 673, and in *General Artists Corp.* v. *Commissioner of Internal Revenue*, 2 Cir., 1953, 205 F. 2d 360, cert. den. 346 U. S. 866, 74 S. Ct. 105. The court felt that the surrender by the tenant and the cancellation and termination of his right to stay in possession "seems closer to those cases holding that gain derived by the holder of a life interest upon sale to the remainderman is to be taxed

as a capital gain" (210 F. 2d 752, 753) citing *McAllister* v. *Commissioner of Internal Revenue*, 2 Cir., 1946, 157 F. 2d 235. In the same year the Third Circuit again considered a problem of the surrender of contract rights to the exclusive product of four machines in exchange for stock in *Commissioner of Internal Revenue* v. *Goff*, 3 Cir., 1954, 212 F. 2d 875, the Commissioner contending that the transfer of these rights constituted ordinary income relied on the *Starr Bros.* and *General Artists* cases in this Circuit but Judge Goodrich pointed out that "the last word on the subject in the Second Circuit is *Commissioner of Internal Revenue* v. *McCue Bros. & Drummond, Inc.*, 2 Cir., 1954, 210 F. 2d 752, which held that payment made by a lessor to a lessee so that he would vacate the premises was a capital gain." He found that "[T]he Starr and General Artists decisions were distinguished on the ground that the rights therein involved were less substantial." Referring to *McCue Bros. & Drummond* he recognized this decision as being "in accord with the cases cited above, and we think it is right" but that "whether the Second Circuit cases are in harmony is not a matter for us to decide" (212 F. 2d 875, 876). The court affirmed the Tax Court decision saying "there is certainly no doubt that the right that Saxon had to the exclusive product of these four machines was a substantial right and, if it is important, it was a right connected with the use of specific tangible property, that is, the machines themselves" (pp. 876, 877).

Legal rights should not be adjudicated by mere choice of words. "There surely cannot be that efficacy in lawyers' jargon that termination or cancellation or surrender carries some peculiar significance vastly penalizing laymen whose counsel have chanced to use them" (*McAllister* v. *Commissioner of Internal Revenue*, *supra*, p. 236). Moreover, here the parties did not even use the word "surrender" but said that Russell had "acquired all of our right and interest." That "there was a 'surrender' to the remainderman, rather than a 'transfer' to third persons * * * does not change the essentially dispositive nature of the transaction so far as the former property owner is concerned" (*McAllister*,

supra, p. 237). So here Pittston had effectively disposed of its property interest. Whether by surrender or transfer or acquisition the legal consequences should be the same.

"Setting the bounds to the area of tax incidence involves the drawing of lines which may often be of an arbitrary nature. But they should not be more unreal than the circumstances necessitate" (*McAllister, supra*. p. 237). Accepting as sound the proposition "that distinctions attempted on the basis of the various legal names given a transaction, rather than on its actual results between the parties, do not afford sound basis for its delimitation" (*McAllister, supra*, p. 237), what distinction should be applied here? Obviously, the $500,000 was not in "anticipation of income payments over a reasonably short period of time" (p. 237) because income was not assured. But even the surrender of life estates to the remaindermen has received consistent recognition by the courts as placing profit in the category of capital gains (*Blair* v. *Commissioner of Internal Revenue*, 300 U. S. 5, 57 S. Ct. 330, 81 L. Ed. 465; *McAllister, supra*; *Bell's Estate* v. *Commissioner of Internal Revenue*, 8 Cir., 1943, 137 F. 2d 454). The suggestion of the majority that the lump sum payment of $500,000 was made "for tax avoidance purposes" and therefore should be considered as ordinary income would be equally applicable to the life estate surrender, leasehold cancellation and agency termination cases.

The Commissioner bases his argument almost exclusively on *Commissioner* v. *Starr Bros., supra*, which he asserts "is not distinguishable in any material aspect." The majority finds the facts of the present case closer to those in *Starr Bros.* than in the cases involving the surrender of the insurance agency contract, the release of a covenant not to rent to a specific type of store, the surrender of a leasehold and a life estate.

To test the applicability of a decision relied upon as a precedent it is always useful to substitute the facts in a reciprocal manner. First applying the *Pittston* facts to Starr Bros., it would be necessary to assume that Starr Bros., a drug store in a city of some 20,000 population, had

agreed to build a factory for the United Drug Company and to purchase its entire output of drugs and distribute them throughout the country for a period of ten years. Conversely, had Russell paid a small amount to Pittston for the privilege of selling some of its coal to others while keeping its contractual relationship with Pittston otherwise in force then an analogous situation might have existed. The mere statement of these hypothetical situations, however, illustrates how lacking they are in factual similarity. The same is true of the *General Artists* case.

I cannot agree that the property rights created by the two agreements between Pittston and Russell were mere "naked contract rights" but find them clothed not only with a mortgage interest in the Russell leasehold until the repayment of the loan but also with sufficient substance to justify specific performance. Nor do I think that the *Starr Bros.* case, which by the court's own analysis was restricted to a small payment for "the taxpayer's release of United's negative covenant," should be determinative or even persuasive here.

In no branch of the law is it more important that there be as much certainty as possible than in the field of taxes. Businessmen and their corporations must often make decisions involving future plans and the expenditure of large sums of money upon the advice of counsel as to the tax consequences of the contemplated transactions. The decision of the majority in the present case injects an unwarranted inconsistency into this field. In my opinion the Tax Court correctly construed the decisions in this as well as the other circuits referred to and its judgment below should be affirmed.

Appendix C.

Excerpts From Statutes of Internal Revenue Code of 1939.

"SECTION 22. GROSS INCOME. (26 U. S. C. 1952 ed. Sec. 22)

(a) General Definition.—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal services, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

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"SECTION 117. CAPITAL GAINS AND LOSSES. (26 U. S. C. 1952 ed., Sec. 117)

(a) Definitions. As used in this chapter—

(1) (As amended by Sec. 115(b), Revenue Act of 1941, c. 412, 55 Stat. 687, and Sec. 151(c), Revenue Act of 1942, c. 619, 56 Stat. 798) Capital Assets.—The term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), or an obligation of the United States or any of its possessions, or a State or Territory, or any political subdivision

thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, or real property used in the trade or business of the taxpayer;

* * * * * *

(4) (As amended by Sec. 150(a)(1), Revenue Act of 1942, *supra*) Long-Term Capital Gain.—The term 'long-term capital gain' means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing net income;

* * * * * *"